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IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

ALBERTSON'S, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether section 404 of the Internal Revenue Code bars the current deduction of interest accrued under a nonqualified deferred compensation plan.

2. Whether central heating, ventilating, and air-conditioning systems installed in supermarkets to meet the temperature and humidity requirements set by manufacturers of refrigerated food cases constitute "tangible personal property" within the meaning of section 48 of the Code.

THE PARTIES BELOW; CORPORATE AFFILIATES

Petitioner Albertson's, Inc., and respondent Commissioner of Internal Revenue are the only parties.

Petitioner has no corporate parent and no nonwholly-owned subsidiaries.

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PETITION FOR WRIT OF CERTIORARI

Albertson's, Inc., hereby petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The opinion of the court of appeals on rehearing (App. A) is reported at 42 F.3d 537. The initial opinion of the court of appeals (App. B) is reported at 38 F.3d 1046. The opinion of the Tax Court with respect to the deduction for interest (App. C) is reported at 95 T.C. 415. The opinion of the Tax Court with respect to the investment tax credit (App. D) is reported at 56 T.C.M. 928. The opinion of the Tax Court with respect to work incentive tax credits (App. E) is reported at 59 T.C.M. 186.

JURISDICTION

The judgments of the court of appeals were entered on December 30, 1993, and December 5, 1994. Timely petitions for rehearing were denied on February 2, 1995 (App. F). This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of sections 38, 48, 163, and 404 of the Internal Revenue Code of 1954, 26 U.S.C. §§ 38, 48, 163, and 404 (1982), of section 404 of the Internal Revenue Code of 1986, 26 U.S.C. § 404 (1994), and of Treas. Reg. § 1.48-1(e)(2), 26 C.F.R. § 1.48-1(e)(2) (1982), are set forth at App. G.

STATEMENT OF THE CASE

Petitioner Albertson's, Inc., operates several hundred retail food and drug stores throughout the western, mid-western, and southern regions of the United States. This federal income tax case relates to petitioner's taxable year ending February 3, 1983. Two separate and distinct questions are presented.

The first question is whether interest accrued in connection with a nonqualified deferred compensation plan may be currently deducted under section 163 of the Internal Revenue Code, 26 U.S.C. § 163 (1982) (unless otherwise noted, references herein to the Internal Revenue Code are to the 1954 Code as in effect during the taxable year at issue). In seeking rehearing below, respondent Commissioner of Internal Revenue candidly advised the Ninth Circuit that this question "is one of exceptional importance to the administration of the federal income tax laws." App. H at 101a.

The second question is whether supermarket heating, ventilating, and air-conditioning ("HVAC") systems constitute "tangible personal property" within the meaning of section 48 of the Code. In deciding this question

adversely to petitioner, the Ninth Circuit explicitly declined to follow the contrary holding of the Eleventh Circuit in *Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572 (11th Cir. 1986). App. B at 40a n.25.

1. *Background.* The facts bearing upon the questions presented are as follows.

a. *Interest on deferred compensation.* Prior to the taxable year at issue in this case, petitioner established a voluntary deferred compensation plan for certain of its senior executives and directors. App. C at 42a. Under this plan, an eligible participant could elect to enter into a deferred compensation agreement and thereby defer receipt of a fixed amount or percentage of his salary or fees until retirement, termination of employment, or attainment of a specified age. *Id.*

Petitioner's deferred compensation plan was not funded. The deferred compensation agreements simply "represented the unsecured contractual obligations of petitioner to pay a specified sum . . . at or after a specified time." App. C at 42a. The amount of compensation thus deferred remained available to petitioner for use in its business as additional working capital or for other purposes. To reflect this fact, and in recognition of the time value of money, the agreements provided that upon payment of the deferred compensation petitioner also would pay "a further sum of money equal to the amount of interest accrued which shall be calculated by applying a rate of interest to the total accumulated amount of deferred compensation including accrued interest compounded monthly. The rate to be used will be the weighted average of [petitioner's] long term borrowing rate for that current fiscal year." *Id.* at 44a. (One of the agreements provided for a different rate of interest, measured by rates on large certificates of deposit. *Id.*)

This deferred compensation plan was not a "qualified plan" for purposes of section 401(a) of the Code. "Strict requirements must be met to achieve qualified

status. The most significant of these requirements relate to the funding of benefits, minimum coverage, prohibitions against discrimination, limitations on the benefits which may accrue to participants, and prohibitions against self-dealing. . . . An employer that contributes to a qualified plan must pay the contributions to a trustee under a trust arrangement or to an insurance company that issues an annuity contract with respect to the plan." App. C at 53a-54a.

An employer may take a current deduction for deferred compensation funded under a qualified plan even though the covered employees may not be required to include the compensation in gross income until they receive payment many years later. *See* App. C at 53a-54a. Pursuant to section 404(a)(5) of the Code, however, deferred compensation accrued under a nonqualified plan "shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but if they satisfy the conditions of either of such sections, they shall be deductible . . . in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan."

Although section 163(a) of the Code grants a deduction for all interest paid or accrued during the taxable year, prior to 1982 petitioner had refrained from taking a current deduction for interest accrued under its deferred compensation plan, in effect treating that interest in the same manner as the deferred compensation itself. In 1982 petitioner requested permission from the Internal Revenue Service ("IRS") to deduct such accrued interest currently under section 163. App. C at 45a. The IRS granted the request. *Id.* "Relying on the permission granted," petitioner then deducted that interest for the taxable year here in issue. *Id.* "In 1987, the IRS changed its mind, however, and sought a deficiency." App. B at 28a. In defending this reversal of position, respondent has contended that the interest accrued under

petitioner's deferred compensation plan constituted "compensation" within the meaning of section 404 or, in the alternative, that section 404 by implication denies a current deduction not only for compensation but also for interest otherwise deductible under section 163.

b. *HVAC systems.* During the taxable year in issue petitioner purchased and installed HVAC systems in 33 new or remodeled food stores. App. D at 71a. "Each of the HVAC systems at issue consisted of a central air handler, compressor, condenser, cooling coils and heat reclaim coils, all of which were connected to a system of duct-work and diffusers. Petitioner's HVAC systems operated 24 hours a day, including hours its stores were closed to customers and employees." *Id.*

"[L]ike most food retailers," petitioner was required to install HVAC systems because of its use of open-front refrigerated food cases. App. D at 74a. Such food cases are designed "to operate properly in stores where temperature and relative humidity were strictly maintained according to certain specifications. All of the manufacturers' specifications for the cases used by petitioner recommended an ambient store environment at or below 75 degrees Fahrenheit and at or below 55 percent relative humidity." *Id.* at 72a. Permitting temperature and humidity to rise above these levels reduces shelf-life and can result in spoilage. *Id.* at 74a. "[T]he failure to use a HVAC system can easily result in lost product, sales and profits." *Id.*

Customers frequently find the required ambient conditions uncomfortable, but those conditions are dictated by the need to meet the temperature and humidity requirements of refrigerated food cases and thereby protect food against spoilage:

> [D]uring the summer months, the outdoor temperatures at the locations of petitioner's stores at issue would often reach or be in excess of 90 degrees Fahrenheit. The variance in petitioner's store temperature and the outdoor temperature created discomfort to

> many customers who complained to petitioner's employees that the stores were uncomfortably cold. Nevertheless, petitioner could not raise its store temperature to accommodate its customers without risking spoilage of its refrigerated food products displayed in open-front cases.

App. D at 74a.

Petitioner sought investment tax credits for its newly installed HVAC systems pursuant to section 38 of the Code. Respondent contested petitioner's entitlement to those credits. Their disagreement centered on "whether petitioner's HVAC systems . . . are tangible personal property within the meaning of section 48(a)(1)(A) and the regulations promulgated under that section." App. D at 76a. Under those regulations, "petitioner's HVAC systems are tangible personal property qualifying for the investment tax credit if they are not 'structural components.'" *Id.* at 77a.

The meaning of the regulatory term "structural components" is discussed as follows in Treas. Reg. § 1.48-1(e)(2) (1982), a legislative regulation that "has the full force and effect of law," App. D at 78a:

> The term 'structural components' includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as panelling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts . . . . *However, the term 'structural components' does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the 'sole justification' test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential.* For ex-

> ample, an air conditioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term 'structural components.'

Id. at 77a-78a (emphasis added by the court). The dispute between petitioner and respondent turned on whether petitioner's HVAC systems met the "sole justification" test propounded by this regulation.

2. *The Tax Court's decisions.* Following respondent's determination of a deficiency, petitioner filed a petition for review in the United States Tax Court pursuant to section 6213 of the 1986 Code. In separate opinions, the court held that petitioner was not entitled to deduct the interest accrued under its deferred compensation plan, App. C, but that petitioner was entitled to an investment tax credit for its HVAC systems, App. D. (In a third opinion, the court decided a question not presented here, involving work incentive tax credits. *See* App. E.)

a. *Interest deduction.* As the Ninth Circuit later observed, the Tax Court was "sharply divided" with respect to the deduction for interest accrued under the deferred compensation plan. App. B at 28a. The case was considered by the full court. Nine judges joined in a majority opinion holding that "[t]he 'interest' factor in petitioner's DCAs [deferred compensation agreements] is not interest within the meaning of section 163. Rather, it is part of the deferred compensation. It is therefore deductible only [when the employee receives payment]." App. C at 59a.

The majority took the position that "interest is a payment for the use of money that the lender had a legal right to possess, prior to relinquishing possession rights to the debtor." App. C at 48a. Noting that a deferred compensation agreement is executed before the partici-

pant has a legal right to receive the compensation, the majority reasoned that "Petitioner could not have 'borrowed' something from the DCA Participants that the DCA Participants never had the right to possess . . . [and therefore] Petitioner cannot properly characterize its accruals as 'interest.' " *Id.* at 50a.

This reasoning was rejected by four concurring judges and five dissenters. The concurring judges (one of whom also joined in the majority opinion) explained:

> [We] do not think that the case turns on whether the 'interest' component of the deferred compensation represents payments made by petitioner for the use of money 'borrowed' from its employees and director. A central focus of the time value of money legislation of the last ten years was to identify hidden interest. Congress clearly understood that transactions involving deferred payments for services contained an interest element. Thus, given our current understanding of the interest element inherent in deferred payment transactions, the majority's analysis seems anachronistic.

App. C at 61a (footnote omitted). These judges reasoned, however, that section 404, which bars the employer from taking a current deduction for compensation until the employee includes that compensation in income, by implication also bars the employer from taking a current deduction for interest: "If the employer were allowed an interest deduction, then the present discounted value of the tax burden on the employer would not be equivalent (i.e., would be less than) an immediate tax on the employee (assuming, of course, equal tax rates). We need not allow that result." *Id.* at 63a (footnote omitted).

The dissenting judges pointed out that " 'interest is . . . paid because of delay in the receipt of funds' . . . [and] it is obvious the additional amounts accrued under the DCA's were accrued because of delay in the receipt of funds." App. C at 65a, quoting *Aames v. Commissioner*, 94 T.C. 189, 193 (1990). The dissent continued:

> Having found the amounts in question are interest, the statute is clear: the deduction is not limited by sections 404(a)(5) and 404(d) . . . . In his concuring opinion, Judge Halpern argues that allowing an employer to deduct interest in advance of inclusion by employees frustrates the matching principle, but it is the prerogative of Congress, not this Court, to change the statutory result. . . .

Id. at 66a.

b. *Investment tax credit.* The Tax Court held that petitioner's installation of HVAC systems in its food stores met the regulatory "sole justification" test and thus qualified for the investment tax credit: "if [petitioner] did not maintain case manufacturers' specifications for store environment, whatever those specifications may be, the quality of its food products displayed in its open-front cases would suffer, resulting in lost product, sales, and profits. It was for this reason that it was crucial to the operation of each of petitioner's retail food stores that each had a HVAC system." App. D at 81a. Under the regulation, it made no difference that the HVAC systems also afforded an "incidental benefit to customers and employees." *Id.*

3. *The Ninth Circuit's initial decision.* The Ninth Circuit initially reversed the Tax Court on both issues.

a. *Interest deduction.* The Ninth Circuit determined that the Tax Court majority had erred in its analysis of what constitutes "interest" under section 163: "a legal right to possession of the assets on which the additional amounts are earned is not necessary in order for those earnings to qualify as interest. . . . The controlling principle [is] not possession, but rather 'compensation for the use or forbearance of money.' " App. B at 30a-31a, quoting *Starker v. United States*, 602 F.2d 1341, 1356 (9th Cir. 1979). Under that test, the court of appeals held, the accrued amounts were interest. In so holding, the court rejected respondent's argument that those

amounts represented not interest but additional deferred compensation, explaining that "[t]he predetermined rate for calculating the additional amounts did not depend in any way upon the amount or type of services performed by the participants." *Id.* at 31a.

The court next determined, "[b]ased on a plain-language reading of the statute," that section 404 does not bar the current deduction of interest accrued under a nonqualified deferred compensation plan. App. B at 33a. The court reasoned that section 404 on its face bars deductions only under sections 162 and 212; Congress could have extended the statute to reach interest deductions under section 163 as well, but it did not do so. "Because we must not 'add to or alter the words employed to effect a purpose which does not appear on the face of the statute,' *Hanover Bank v. Commissioner*, 369 U.S. 672, 687 (1962), we hold that . . . the timing restrictions of section 404 were inapplicable to interest deductions." *Id.* at 35a. This conclusion, the court believed, was confirmed by the legislative history, which "mentions only 'compensation.' . . . [T]here is no indication in the legislative history of section 404 that Congress intended it to apply to interest." *Id.*

b. *Investment tax credit.* The Ninth Circuit rejected the Tax Court's determination that petitioner's installation of HVAC systems in its food stores met the regulatory "sole justification" test because, according to the court of appeals, those systems serve "two additional significant purposes: ventilation and customer comfort." App. B at 38a. The court believed that the regulation's reference to comfort as an acceptable incidental benefit "applies only to *employees*." *Id.* at 39a (emphasis in original). Accordingly, the court expressly declined to follow *Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572 (11th Cir. 1986), "in which the Eleventh Circuit held that costs for a similar HVAC system qualified for an investment tax credit." *Id.* at 40a n.25.

4. *The Ninth Circuit's decision on rehearing.* Respondent filed a petition for rehearing and suggestion for rehearing *en banc* asking the Ninth Circuit to reconsider its holding with respect to the current deductibility of interest under nonqualified deferred compensation plans. Respondent described this issue as "one of exceptional importance to the administration of the federal income tax laws" and stated that "if the panel's decision were to be applied nationwide, the reduction in federal tax receipts could total $7 billion from Fiscal Year 1994 through Fiscal Year 1999." App. H at 101a. The original panel thereupon granted rehearing and proceeded to "change[] our minds about the result we reached in our original opinion." App. A at 5a.

The court acknowledged that interest accrued under a nonqualified deferred compensation plan is currently deductible "under a literal reading of the statutory language." App. A at 16a. The court reasoned, however, that the purpose of section 404 is "to ensure matching of income inclusion and deduction between employee and employer under nonqualified plans," *id.* at 11a, and "to encourage employers to create qualified plans for their employees." *Id.* at 13a. Concerned that a failure to extend the perceived "matching principle" to interest could weaken the incentive to establish qualified plans, the court refused to adhere to the "plain language interpretation" of its initial decision. *Id.* at 17a. Instead, the court reasoned that "despite the literal wording of the statute, Congress could not have intended to exclude interest payments, a substantial part of the deferred compensation package, from the rule prohibiting deductions until such time as the employee receives his benefits." *Id.* at 18a.

REASONS FOR GRANTING CERTIORARI

This unusual case presents two federal income tax issues that should be decided dispositively by this Court. The first issue, involving the current deductibility under section 163 of interest accrued under nonqualified deferred compensation plans, unquestionably is one of great significance under the Internal Revenue Code. Respondent concedes that this is so. In a petition for rehearing *en banc* authorized by the Solicitor General, respondent represented to the Ninth Circuit that this issue "is one of exceptional importance to the administration of the federal income tax laws" and that "[b]y any measure, this is a case of major fiscal importance." App. H at 101a, 102a. Respondent estimated the short-term revenue implications at seven billion dollars nationwide, and at two billion dollars in the Ninth Circuit alone. *Id.*

The ruling in this case is likely to "affect[] just about every nonqualified deferred compensation plan in the country." Tom Herman, *U.S. Appeals Court Overturns its Ruling in High-Stakes Tax Case*, Wall St. J., Dec. 6, 1994, at B12. There are thousands of such plans; their use is widespread throughout the corporate world. As respondent advised the Ninth Circuit, "more than 60% of the Fortune 500 utilize nonqualified deferred compensation plans . . . [and] [t]he use of such plans is not limited to major corporations." App. H at 101a. Hundreds if not thousands of corporate taxpayers, including many of the nation's largest companies, will be directly affected by the outcome of this case.

The publicity and attention given to the issue by both professional journals and the business press attest to its importance. Professional commentary on the decisions below has become something of a cottage industry. *See* J. Cummings, "Statutory Interpretation and *Albertson's*," Tax Notes, Jan. 23, 1995, p. 559 at 560 n.3 (citing 12 law review articles published within a period of less than eight months). Appealing to a more general readership, the Wall Street Journal has discussed the case on no

fewer than six occasions. *See* Wal' St. J. at B12 (Dec. 6, 1994); *Tax Report*, Wall St. J., June 29, 1994, at A1 ("the case will have a very broad impact"); *Tax Report*, Wall St. J. April 27, 1994, at A1; *Tax Report*, Wall St. J., April 6, 1994, at A1 ("an enormously important case"); *Tax Report*, Wall St. J. Feb. 9, 1994, at A1; *Tax Report*, Wall St. J., Jan. 19, 1994, at A1.

When it reversed itself, the Ninth Circuit explicitly recognized that the issue merits review by this Court: "The question is not an easy one . . . . We have struggled with it unsuccessfully at least once, and it may, indeed, ultimately turn out that the United States Supreme Court will tell us that it is this [second] opinion which is in error." App. A at 5a. This Court should accept the Ninth Circuit's invitation to review the case and proceed to fulfill that court's prophecy that its erroneous decision on rehearing will be overturned.

The second issue, involving the proper characterization under section 48 of HVAC systems used in retail food stores, also is important. There is a direct and acknowledged conflict between the Ninth and Eleventh Circuits on this issue. *See* App. B at 40a n.25.

This second issue affects virtually every owner of a modern food store, including not only operators of major supermarket chains like petitioner but also smaller establishments operating just one or a small number of stores. Although there inevitably is a factual element in determining whether an item constitutes "tangible personal property" within the meaning of section 48, the essential facts relating to HVAC systems are invariant for all modern food stores: (1) proper operation of open-front refrigerated food cases depends upon the maintenance of strict controls on ambient temperature and humidity, and thus upon the installation and use of an HVAC system; (2) HVAC systems also may incidentally provide for the comfort of customers and employees. *See* App. D at 75a-76a. In this context, the case of one supermarket

chain is not factually distinguishable from that of another. *Id.* at 79a. The Ninth Circuit evinced its understanding that the underlying issue is one of law rather than fact when it expressly "decline[d] to follow the Eleventh Circuit's holding" in *Piggly Wiggly Southern, Inc. v. Commissioner*, 803 F.2d 1572 (11th Cir. 1986), and chose instead to follow the contrary holding in *Publix Supermarkets, Inc. v. United States*, 26 Cl. Ct. 161 (1992). App. B at 40a n.25.

This conflict among the circuits should be resolved. Such a conflict is of particular concern in the supermarket industry, where nationwide chains operating on low margins compete with one another in many circuits. This case dramatizes that concern. Petitioner operates scores of food stores within the geographical area of the Eleventh Circuit, in direct competition with Piggly Wiggly. Yet because of the disagreement between the Ninth and Eleventh Circuits, petitioner suffers a distinct tax disadvantage. A circuit conflict that imposes different cost structures on direct competitors in the same local market should not be allowed to persist.

Although the investment tax credit was repealed by the Tax Reform Act of 1986, the underlying issue on which the Ninth and Eleventh Circuits disagree—the application of the "sole justification" test under Treas. Reg. § 1.48-1(e)(2) to supermarket HVAC systems—is one of continuing significance. The issue remains extremely important in the context of the deduction for depreciation. In defining "section 1245 property," Treas. Reg. § 1.1245-3(c)(2) expressly incorporates the definition of "structural components," including the "sole justification" test, contained in Treas. Reg. § 1.48-1(e)(2). The term "section 1245 property" is then used to determine whether property is real or personal for purposes of accelerated depreciation under section 168 of the 1986 Code. *See* Treas. Reg. § 1.168-3(c). Considerable tax liability and revenue must turn on that distinction: whereas non-

residential real property is subject to straight line depreciation over a lengthy 39-year recovery period, tangible personal property can qualify for 200 percent declining balance depreciation over a much shorter five-year recovery period. *See* section 168(b) and (c) of the 1986 Code.

In addition, the regulatory definition of "structural components" and the "sole justification" test continue to apply in at least three other situations under the 1986 Code. *See* Treas. Reg. § 1.168-3(c)(4) (depreciation recapture); Treas. Reg. § 1.897-1(b)(3)(iv) (disposition of certain foreign-owned property); section 47 of the Code (rehabilitation tax credit). The question whether supermarket HVAC systems meet the "sole justification" test, therefore, retains substantial vitality under current law. This Court should grant certiorari to resolve the circuit conflict on this issue created by the decision below.

Review of this case is further warranted because, as the following discussion demonstrates, both questions presented were incorrectly decided by the court of appeals.

I. *Section 404 does not bar the current deduction of interest accrued under a nonqualified deferred compensation plan.* Section 163(a) of the Code allows a deduction for "all interest paid or accrued within the taxable year on indebtedness." It has long been understood that "interest," within the meaning of this provision, retains its "usual, ordinary and everyday meaning," *Old Colony R.R. Co. v. Commissioner,* 284 U.S. 552, 561 (1931), and refers to an obligation to pay "for the use or forbearance of money." *Deputy v. du Pont,* 308 U.S. 488, 498 (1940). That definition fits this case like a glove. Under the terms of its deferred compensation agreements, petitioner became indebted to the participants for the amounts of their deferred compensation, and it undertook to accrue and ultimately to pay interest on that indebtedness at rates fairly representing the time value of money. App. B at 30. Petitioner's contractual obligation to pay interest on the funds thus borrowed from the

participants plainly "qualified as interest under the Code." *Id. See also* Note, "Employer Deductions Under Nonqualified Deferred Compensation Agreements: *Albertson's, Inc. v. Commissioner,*" 48 Tax Lawyer 493, 500-02 (1995); L. Shapiro & W. Pomierski, " 'Interest' on Deferred Compensation Arrangements May Be Deductible, for Now," J. Taxation 212, 213 (April 1994).

Even on rehearing, the Ninth Circuit did not disturb its prior determination that petitioner had accrued "interest . . . on indebtedness" within the meaning of section 163(a). The court conceded, moreover, that "under a literal reading of the statutory language, the deduction of interest is not affected by section 404." App. A at 16a. The court nonetheless held that section 404 must be construed as forbidding a current deduction for interest accrued under a nonqualified deferred compensation plan because, it believed, permitting a deduction would "undermine[] Congress' attempts to encourage employers to adopt qualified plans." *Id.* This "argument proves too much because it would support any limit on tax benefits related to nonqualified plans." J. Cummings, *supra*, Tax Notes at 572.

As written, section 404 favors qualified plans over nonqualified plans by allowing employers to take a current deduction for deferred compensation in connection with the former but not the latter. This alone is sufficient to provide a meaningful tax incentive for the adoption of qualified rather than nonqualified plans. *See* R. Dema & K. Frazier, "The Real Cost of Nonqualified Deferred Compensation Plans," J. Accountancy 86 (March 1995). The Ninth Circuit was gilding the lily when it went further and also barred employers with nonqualified plans from taking a current deduction for interest under section 163. The creation and limitation of tax incentives is, of course, a matter solely for Congress. Congressional enactment of a single, narrowly circumscribed tax incentive or disincentive plainly does not warrant the judicial

creation of still further incentives or disincentives that Congress itself did not see fit to legislate.

The decision below stands as a triumph of judicial policymaking over straightforward statutory construction. The Ninth Circuit "is in full rout before the intimidating force of 'tax logic,' i.e., what the code should say, whether it says so or not." J. Cummings, *supra*, Tax Notes at 559. That approach to statutory construction is seriously misguided and ultimately quite mischievous. "Going behind the plain language of a statute in search of a possibly contrary congressional intent is a 'step to be taken cautiously' even under the best of circumstances." *American Tobacco Co. v. Patterson*, 456 U.S. 63, 74-75 (1982). In this case, "there is simply no evidence that Congress intended to extend [section 404] to a deduction for interest." L. Shapiro & W. Pomierski, *supra*, J. Taxation at 214. Furthermore, "the legislative purpose perceived by the appeals court is nothing more than the court's own preference among competing policy considerations . . . ." E. Zelinsky, "*Albertson's*: Why Courts Shouldn't Override Clear Statutory Language," Tax Notes, March 13, 1995, p. 1691 at 1697.

Although the Ninth Circuit erred in both its path of reasoning and its final result, the court nonetheless was correct in acknowledging that the "plain language" of section 404 permits a current deduction for interest. App. A at 16a. Section 404 by its terms postpones the deduction only of "compensation." "The plain meaning of compensation here is payment for services." J. Cummings, *supra*, Tax Notes at 562. The underlying regulation confirms that section 404 is concerned solely with "compensation *for personal services actually rendered*." Treas. Reg. § 1.404(a)-1(b) (emphasis added). That also is the meaning of the same term elsewhere in the Code. *See, e.g.*, Treas. Reg. § 1.162-7(a) (defining compensation as "payments purely for services"). "It is a 'normal rule of statutory construction . . . that identical

words used in different parts of the same act are intended to have the same meaning.'" *Commissioner v. Keystone Consol. Indus., Inc.*, 113 S.Ct. 2006, 2011 (1993), quoting *Sorenson v. Secretary of Treasury*, 475 U.S. 851, 860 (1986). *See also, e.g., Commissioner v. Lester*, 366 U.S. 299, 304 (1961).

Nothing in either the text of section 404 or its legislative history suggests that Congress was using "compensation" to refer to interest on indebtedness as well as compensation for services. Such use would have been harshly discordant with congressional treatment of interest and compensation elsewhere in the Code:

> the code normally deals with interest and compensation explicitly and separately. Section 61 separately identifies interest, compensation, and other income items; sections 162, 163, and 267 do the same for deduction purposes. . . .
>
> Presumably, Congress meant compensation and not interest in section 404(a), because it knew that the code deals separately with compensation and interest.

J. Cummings, *supra*, Tax Notes at 564. When Congress has wished to refer both to compensation and interest in connection with deferred compensation arrangements, it has known how to do so. *See* section 457(a) of the 1986 Code (referring to "any amount of compensation deferred under the plan, *and any amount attributable to the amounts so deferred*") (emphasis added). Congress did not do so in section 404.

The text of section 404(a) as in effect during the taxable year at issue made explicit that only the deduction for compensation, and not that for interest, was subject to postponement: "if compensation is paid or accrued on account of any employee under a [nonqualified] plan deferring the receipt of such compensation, such . . . compensation shall not be [currently] deductible under section 162 (relating to trade or business expenses)

or section 212 (relating to expenses for the production of income)." There was no reference to, and no bar against, the current deduction of interest under section 163.

The explicit statutory reference to sections 162 and 212 was removed in 1986, and section 404(a) now provides that deferred compensation may not be currently deducted "under this chapter." The limited purpose of this amendment, which the Senate Report described as a mere "clarification," was "to prevent taxpayers from asserting that deferred compensation is attributable to capitalizable compensation expenses and, thereby, accelerate the timing of the deduction for such deferred compensation." S.Rep. No. 313, 99th Cong., 2d Sess. 1, 1013 (1986). In other words, Congress was just making clear that section 404 governs the deduction of deferred compensation that might otherwise be subject to capitalization and depreciation under section 167. *See Idaho Power Co. v. Commissioner*, 418 U.S. 1 (1974).

The 1986 amendment did not widen the focus of section 404(a); the statute remains narrowly addressed to the deductibility of "compensation." The amendment thus does not detract from the importance of the question presented or bear upon the correct analysis of that question under the statute. *See* App. B at 36a. Current Treasury regulations, issued in 1986 and amended as recently as 1992, confirm that section 404 analytically is no different now than in 1982 and that the statute remains today, as in 1982, concerned solely with the timing of the deduction for compensation normally deductible under section 162 or 212: "Section 404(a) and (d) require that . . . [deferred] compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections." Temp. Treas. Reg. § 1.404(a)-1T, Q&A-1, as amended by T.D. 8435, 1992-2 C.B. 324. In short, section 404 is not now, and was not in 1982, addressed to

or concerned with the current deductibility of interest under section 163.

In view of this background, it is not surprising that from 1977 until the time of the Tax Court's decision in this case one of the most widely distributed tax commentaries, the Standard Federal Tax Reporter published by Commerce Clearing House, advised that interest accrued under nonqualified deferred compensation plans is currently deductible under section 163. *See, e.g.*, [1977] 3 Stand. Fed. Tax Rep. (CCH) ¶ 2656A.25. As *amici curiae* Connecticut Mutual Life Insurance Company *et al.* demonstrated in their briefs below, this advice has been widely followed. The decision below on rehearing disappointed many taxpayers' settled expectations. Respondent's representation to the Ninth Circuit concerning the immediate revenue consequences of its initial decision, *see* App. H at 101a, appears to provide a fair measure of the extent of that disappointment. Taxpayers with nonqualified plans who had not previously claimed a current deduction for accrued interest could not begin to do so in the wake of the Ninth Circuit's initial decision without first securing respondent's permission to change their method of accounting—permission that respondent had discretion to deny and announced would be denied. *See* IRS Notice 94-38, 1994-1 C.B. 350; Rev. Proc. 92-20, 1992-1 C.B. 685, 703. The revenue estimates respondent furnished to the court thus presumably were based largely if not entirely on those taxpayers who, like petitioner, already were claiming the deduction.

The Ninth Circuit's result cannot be rationalized on policy grounds. In the first place, of course, "[i]f highly specific terminology in the tax code is to be overturned, that task belongs to Congress, not to the courts." Zelinsky, *supra*, Tax Notes at 1692. But beyond that, the court's choice of policy was highly dubious. The court was concerned to prevent petitioner from taking a deduction before its plan participants recognized income. But it is commonplace under the Code for one taxpayer to claim a deduc-

tion in one year and for another taxpayer to recognize the income relating to that deduction in a subsequent year. As one commentator has observed, "Every time an accrual-method taxpayer accrues an unpaid deduction attributable to an amount owed a cash-method taxpayer, an inconsistency arises. Every time. And, so what." S. Willis, "Leave *Albertson's* Alone," Tax Notes, June 13, 1994, p. 1481 at 1488. This "inconsistency" is merely a natural consequence of the right taxpayers have under the Code to choose between cash-basis and accrual-basis accounting. It is not a problem that cries out for judicial correction (nor is it, indeed, properly amenable to judicial solution).

The Ninth Circuit nonetheless became persuaded that section 404 should be applied to deal with this situation more broadly than its literal language would suggest, *i.e.*, as embodying a broad "matching principle" that requires all of an employer's deductions relating to nonqualified plans to be matched with an employee's recognition of income. *See* App. A at 11a-12a. The court thus lost sight of the Code's more general underlying matching principle: for any given taxpayer, "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of [that taxpayer's] net income for tax purposes." *Indopco, Inc. v. Commissioner*, 112 S.Ct. 1039, 1043 (1992). Section 404 constitutes a specific exception to this more general principle and as such should be narrowly construed, in accordance with its plain language, as applying only to compensation and not to interest. The Code's general matching principle directly supports the current deduction of interest accrued on borrowed funds that are used currently as working capital or otherwise to produce revenues in a taxpayer's business. It directly supports, in other words, petitioner's current deduction of interest under section 163.

By forcing petitioner to defer its interest deduction, the Ninth Circuit in fact "appl[ied] a solution . . . that Congress rejected." S. Willis, *supra*, Tax Notes at 1486. In section 467(g) of the 1986 Code, Congress delegated to the Secretary of Treasury authority (which the Secretary has not exercised) to promulgate regulations requiring, in connection with certain substantial deferred compensation arrangements, that even cash basis employees must recognize interest income in the year of accrual. Congress evidently understood that, absent such regulations, the Code itself does not require, explicitly or implicitly, that an employer's interest deduction be matched with the employee's recognition of income. Congress concluded, moreover, that in those circumstances where the Secretary determines that such matching is appropriate, it should be achieved by accelerating the employee's recognition of income, not by postponing the employer's deduction. The policy judgment reflected in section 467(g) thus is diametrically opposite the approach taken by the court below.

The policy the Ninth Circuit favored—requiring an accrual basis taxpayer to defer a deduction for accrued interest until it becomes includible in the gross income of a cash basis recipient—actually is reflected in section 267 of the Code. The reach of that provision, however, is narrowly and deliberately restricted to transactions between specifically identified parties, such as a corporation and a majority shareholder, or the fiduciary and beneficiary of a trust. Congress could have extended this rule to transactions between a corporation and its employees and thereby covered this case as well. But Congress did not do so. The Ninth Circuit should have been content to follow Congress' lead. The court obviously erred in departing from the actual text of the Code to devise and enforce its own idiosyncratic and nonstatutory tax policy.

The undeniable importance of the question presented under section 404, the Ninth Circuit's improper result-oriented reasoning process in addressing this question,

and the court's manifestly incorrect result, all lead ineluctably to the conclusion that "*Albertson's* is the rare corporate income tax case worthy of review by the Supreme Court even before a conflict is established among the circuits." E. Abahoonie, "Ninth Circuit's *Albertson's* Flip-Flop Outrages Practitioner," Tax Notes, Feb. 6, 1995, p. 898.

II. *Supermarket HVAC systems constitute "tangible personal property" within the meaning of section 48.* The investment tax credit provided by section 38 of the Code extended to investments in so-called "section 38 property," which section 48(a)(1)(a) defined as including "tangible personal property." The latter term is defined by Treas. Reg. § 1.48-1(c) to exclude "structural components of . . . buildings." In turn, Treas. Reg. § 1.48-1(e)(2) provides that "the term 'structural components' does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet the temperature and humidity requirements which are essential to the operation of other machinery." Thus HVAC systems qualified for the investment tax credit if, within the meaning of Treas. Reg. § 1.48-1(e)(2), the "sole justification" for their installation was to meet the temperature and humidity requirements of open-front refrigerated food cases.

Respondent concedes that "petitioner's retail food stores require HVAC systems to keep ambient store temperature within case manufacturers' specifications and prevent spoilage." App. D at 79a. This now is a standard characteristic of food stores generally: "Unlike other commercial buildings, supermarkets do not base air conditioning on comfort considerations. Rather, air conditioning works together with the refrigerators in keeping perishable foods at proper temperature." Tr. 220-21 ("Tr." refers to the trial transcript). The Department of Energy recognized this industry-wide phenomenon when it proposed regulations exempting food stores from heating and cooling standards applicable to other business

establishments, noting that "temperature and humidity levels other than those mandated in the regulations are required . . . for the proper refrigeration of perishable items on open shelf units." 44 Fed. Reg. 31927, 31928 (1979). *See also* App. D at 75a.

The Ninth Circuit nevertheless held that meeting the requirements of refrigerated food cases cannot be considered the "sole justification" for installing HVAC systems in food stores, because such systems also provide "ventilation and customer comfort." App. B at 38a. Although the court couched its reasoning in terms of "clear error," *id.* at 39a, its holding was not grounded in either the particular facts of this case or any evidence pertaining to the industry generally. Both petitioner and respondent presented evidence that suitable ventilation is an integral part of any system designed to maintain the temperature and humidity conditions necessary for the proper operation of in-store food refrigeration equipment. See Tr. 435; Cmr. Exs. EA and EF ("Cmr. Ex." refers to respondent's trial exhibits). That is, indeed, little more than common sense. As to customer comfort, moreover, there is abundant evidence that, in fact, customers frequently criticize both petitioner's supermarkets and those of its competitors for being uncomfortably cold. *See, e.g.*, App. D at 74a; *Piggly Wiggly*, 803 F.2d at 1576 n.16.

At bottom, the Ninth Circuit's decision turned on its erroneous construction of the regulatory term "sole justification" to mean "exclusive justification." Although Treas. Reg. § 1.48-1(e)(2) does not comprehensively define "sole justification," it does make clear that the phrase is not to be construed literally as disallowing a secondary or incidental purpose for the installation of HVAC systems:

> Machinery may meet the "sole justification" test . . . even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential. For example, an air condi-

> tioning and humidification system installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical when processing particular types of yarn or cloth is not included within the term "structural components."

Consequently, "sole justification" cannot be equated with "*exclusive* justification." *Piggly Wiggly*, 803 F.2d at 1575 (emphasis in original). Instead, the regulation calls for a "balancing of the 'sole justification' versus 'incidental benefits.'" *Id.*

The Ninth Circuit explained its refusal to undertake such a balancing on the ground that the regulatory "comfort exception applies only to *employees*." App. B at 39a (emphasis in original). That reading of the regulation defies common sense. In referring to the comfort of employees, the regulation merely furnishes a specific illustration of the application of a more general rule, *i.e.*, HVAC systems that are essential to the operation of other machinery do not become "structural components" merely because they afford the incidental benefit of a more comfortable environment. A distinction between the comfort of employees and that of customers in this context has no rational bearing on whether an HVAC system should be considered a "structural component," and the regulation in fact does not draw any such distinction.

Rationally construed, Treas. Reg. § 1.48-1(e)(2) is not concerned with the identity of those who may be incidentally benefitted by the installation of an HVAC system, whether they are customers, suppliers, employees, or other business invitees. As the Eleventh Circuit correctly understood, the "sole justification" test is satisfied whenever HVAC systems are installed "to meet equipment specifications [even though] *customer and worker* comfort was an incidental benefit." *Piggly Wiggly*, 803 F.2d at 1575 (emphasis added). In short, even if supermarket customers are made more comfortable as a result of the installation of new HVAC systems—and there is evidence

that they frequently are not, *see, e.g.*, App. D at 74a—such systems nonetheless satisfy the regulatory "sole justification" test.

The conflict between the Ninth and Eleventh Circuits leaves the law unsettled on an issue of considerable continuing practical significance and will encourage further litigation. This Court can nip that growth of litigation in the bud by resolving the conflict now. Indeed, the Court has the opportunity to, and should, "kill two birds with one stone" by accepting and deciding both of the important questions of federal income tax law presented in this case.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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